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Report No. 200, July 24, 1991

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Southeast Asian fears about the colossus to the north have deep roots, but Beijing has greatly improved its image and prospects for playing an influential role in the region. Skillful diplomacy, cessation of aid to revolutionary movements, and China's emergence as a significant trading country have enabled Beijing to strengthen its political and economic ties with ASEAN members. The marked improvement of PRC-ASEAN relations since Tiananmen contrasts sharply to the downturn in relations with the West.

China's relations with southeast Asia have improved markedly in the past three years and are reflected in now-frequent high-level exchanges, re-establishment of relations with Indonesia and Singapore, and steadily growing economic ties. Sino-Thai relations are particularly strong, and also extensive, in part because of cooperation on Cambodia-related issues for more than a decade. PRC-Philippine relations are basically good, though Manila's susceptibility to Taiwanese economic blandishments remains a source of strain. Brunei is the only ASEAN member without diplomatic ties to Beijing. After bilateral talks on July 20, Brunei's foreign minister said he hoped to establish ties in the "not too distant future."

Ceremony and symbolism. President Yang Shangkun's June visits to Indonesia and Thailand were in many ways indicative of PRC-ASEAN relations. The visits were long on ceremony and reassuring statements and short on concrete achievement. But they looked forward to steadily improving relations rather than backward to such formerly troublesome issues as PRC relations with--and manipulation of--overseas Chinese communities in ASEAN countries. This has been a particularly sensitive issue in Indonesia and Malaysia.

Cambodia and beyond. Vietnam's invasion of Cambodia in 1978 and China's subsequent support for the Khmer resistance and, perhaps more important, Thai security, enabled Beijing to broaden and deepen ties with

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all of ASEAN but especially Thailand. For more than a decade Beijing has sought to depict Vietnam, not China, as the principal threat to regional security. In the process it has forged important military ties with Thailand and strengthened economic links with Malaysia, Singapore, and, more recently, Indonesia.

Cambodia provided an opening for China to improve relations with ASEAN; it has used that opportunity effectively. This year, for the first time, the Chinese--and the Soviets--were invited to the opening of the ASEAN ministerial. The Malaysian host later announced that ASEAN and China would step up economic and political cooperation.

ASEAN nonetheless remains wary of the PRC and concerned about a number of smoldering issues. Among them are competing claims to the Spratly islands (and their presumed seabed resources). Indonesia's hosting of an informal seminar on the Spratlys last week was intended to help defuse the issue and to explore PRC expressions of willingness to pursue joint development if others would acknowledge Chinese sovereignty.

Other potential areas of conflict include trade friction (allegations of Chinese dumping and failure to correct trade imbalances), ASEAN concerns that local Chinese businessmen will redirect investment funds from their own country to the PRC, and friction over ASEAN relations with Taiwan. (MFinegan) (CONFIDENTIAL)

II. CAMBODIA: PROGRESS IN BEIJING, BUT QUESTIONS REMAIN (7/21)

The Khmer factions made further progress toward a settlement at the "informal" Beijing meeting of the Supreme National Council (SNC). Prince Sihanouk was actively engaged and skillfully secured agreement to several important procedural questions, but there was little movement on core issues such as demobilization of the armies, the extent of UN authority, or the modalities of an election. The Khmer Rouge have acquiesced to Sihanouk's proposals, probably because of Chinese pressure to compromise. Phnom Penh has sacrificed little and seems better positioned than its rivals to benefit from an eventual settlement agreement.

An agreeable though cautious Khmer Rouge. Beijing apparently has decided it wants to settle the Cambodian question quickly and needed to urge the Khmer Rouge to be more flexible. The Khmer Rouge, smarting from criticism of their inflexibility at Jakarta in early June and despite misgivings, have acquiesced to steps at Pattaya and Beijing that deviate from their former requirements for a comprehensive solution. They have abandoned insistence on complete acceptance of the Perm Five draft accord, though they seem to hope most of its provisions, particularly a large UN role, will be adopted.

The Khmer Rouge may be playing a double game--they also seem to see the SNC as largely replacing the Phnom Penh regime and performing the functions they once envisaged for a four-faction interim administration. China too seems to envisage an active SNC rather than the passive body called for by the draft accord. It is likely in any case that both

Beijing's attitude and their own lack of military progress have caused the Khmer Rouge to conclude their best chance is in a political settlement, even under less than ideal conditions.

Phnom Penh looks to Sihanouk. The regime has many reasons for wanting to end the conflict, but whether it is under pressure from Hanoi to yield on fundamental issues is unclear. Hun Sen's strategy seems to be to lure the SNC and Sihanouk to Phnom Penh and to minimize the UN's role. Given the current momentum and Sihanouk's obvious engagement, the regime is unlikely to feel obliged to accept significant parts of the Perm Five plan to accomplish this goal.

Phnom Penh sees the SNC more as an ornamental appendage to its own de facto power than as a supra-government, however, and has welcomed statements of intent to appoint international representatives to the SNC.

The regime may be disquieted by the long-term prospect of Sihanouk's presence among its (and his) own people and the anomaly of armed representatives of the Khmer Rouge "genocidal gang" installing themselves in the capital, but it probably hopes for some sort of "Khmer solution" in which present regime leaders could continue to control most levers of power. It may calculate that if the Khmer Rouge decide eventually to retreat to the jungle, Sihanouk and the international recognition and aid accorded the SNC will remain.

Outlook. Phnom Penh, with Hanoi's apparent continued backing and a host of nations eager to declare the crisis over, seems better placed than its rivals to maintain its vision of how the situation should evolve. The danger it runs is that without an agreed settlement, China may at some point abandon its present forbearance and once again give unconstrained backing to the Khmer Rouge.
(SJohnson) (CONFIDENTIAL)

III. CHINA: REGULARIZING ARMS SALES PROCEDURES (7/22)

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IV. INDOCHINA: REFUGEE REPATRIATION 7/21)

A number of recent developments have brought Indochina refugee issues again to the forefront of ASEAN's agenda. In early June the British began a series of meetings with the Vietnamese over the establishment of internationally managed centers in Vietnam for screened-out Vietnamese asylum-seekers. Progress in negotiations among the Cambodian factions has led to renewed hope for repatriation of Cambodians on the Thai border. After meetings last month, the UNHCR is working with Lao and Thai officials on a plan to send home tens of thousands of Hmong refugees in Thailand.

Refugee ebb and flow. Arrivals in Hong Kong, the favored destination for Vietnamese boat people, have dropped from a June peak of more than 150 a day to less than half that level. The beginning of the typhoon season probably accounts for the decline. Hong Kong's voluntary repatriation program, meanwhile, having come to a virtual standstill in the spring, is now back to 1990 levels of 600 volunteers a month. An increasing number of refugees have voluntarily returned from Thailand, Malaysia, and Indonesia in the past two months. The UNHCR speculates there could be as many as 2,000 returnees from the region in July. Malaysia continues to deny new arrivals first asylum; in May a boatload of 110 people was refused.

Internationally managed centers. Vietnamese and British officials, along with representatives from the UNHCR and the International Organization for Migration (IOM), have now reached agreement on running the centers. The IOM will manage them, and the UNHCR will focus on protection and monitoring issues; a pilot facility is proposed near Haiphong. Important hurdles still to be overcome are continued Vietnamese reluctance to surrender sovereignty over the centers and Hanoi's opposition to forced movement from Hong Kong.

The Vietnamese are reviewing an IOM-UNHCR non-paper on extra-territoriality issues. The Vietnamese also worry that potential US criticism of the program will delay lifting of the trade embargo; they will probably seek US endorsement of the centers before reaching an agreement with Hong Kong. Other ASEAN countries will be watching to see how the program works and may participate themselves if the Hong Kong program is successful.

Cambodia. Drought and fighting this spring have displaced nearly 200,000 Khmer inside Cambodia, the highest number in over a decade. Relief officials want at least six months to remove mines and make other preparations before repatriating more than 300,000 Khmer in camps on the Thai-Cambodia border. The recent momentum in Khmer peace talks has raised concerns that some Cambodians may attempt to return before adequate arrangements have been made.

Laos. UNHCR, Lao, and Thai officials have developed a plan to return 62,000 refugees, mostly Hmong, to Laos by May 1994. Though a modest UNHCR-sponsored repatriation program for lowland Lao has been in place for several years, the vast majority of those in the new program will be highlanders. A pilot reintegration project scheduled to open in August will help determine how many Hmong will return "voluntarily."
INR/GE:JWysham) (CONFIDENTIAL)

V. CHINA: GROWING CAPITAL MARKETS

The July 3 official opening of China's second stock exchange reflects the continued growth of capital markets in the PRC, despite the apparent domination of economic conservatives. Stocks represent only a small fraction of the developing capital market, but secondary markets for bonds and treasury bills are widespread, and nearly one-third of China's foreign exchange transactions take place in quasi-market "swap centers." Beijing is even experimenting with its first grain futures market.

Conservatives have continued capital market experiments begun in earlier, more reformist days because of their value in raising investment funds, financing the government deficit, and soaking up potentially inflationary cash. Motivations aside, even Premier Li Peng--who looks out for state enterprises first--has sanctioned cautious experimentation with "socialist shareholding" and stock markets.

Bonds. From 1981-90, the PRC issued more than \$30 billion in securities, about 60 percent in the form of treasury bonds. At first, bonds were forced on enterprises and state workers, carried low interest rates, and had long maturities. By the late 1980s, China moved toward shorter-term bonds with interest rates pegged to inflation. Beginning in 1988, Beijing allowed development of secondary bond markets--more than 60 cities now have one--with hundreds of securities companies authorized to trade. These markets may have done about \$1 billion in business in 1990. In April, Beijing issued about one-fourth of this year's T-bills through an underwriting syndicate, significantly reducing the amount of compulsory individual purchases and signalling growing market maturity.

Since 1984, bank and enterprise bonds have also proliferated. Early concern about the credit-worthiness of issuing firms and government objections that funds were being raised for unapproved construction are slowly being worked out, and a credit-rating system requiring independent risk assessments is emerging. Last December, China opened a national securities exchange, initially linking six cities in an incipient national capital market.

Foreign exchange. One of Beijing's earliest reforms in the 1980s was to allow exporting firms and localities to retain a portion of earned hard currency. As foreign investment grew and demand rose for a more flexible system to allocate foreign exchange, Beijing opened "swap centers" through which hard currency holders could trade foreign exchange for Chinese currency at higher-than-official exchange rates. Swap centers in most major cities now handle up to 30 percent of China's foreign exchange transactions. With progressive devaluation of the yuan, officials expect half of all transactions to be handled by swap centers within a few years. Beijing is also considering allowing individuals--who hold \$2 billion in hard currency accounts--to trade at swap markets.

Stocks. Despite ideological and practical reservations, Beijing has allowed continued development of stock issuance and trading. Markets in Shenzhen and Shanghai are now formally open after months of "experimentation." Only a handful of stocks are traded--eight firms are listed in Shanghai, six in Shenzhen--and more than three-fourths of the shares in these firms are government-owned and not subject to trading. But both Shenzhen and Shanghai expect to expand significantly the number of firms listed and shares available by year's end, and other cities are ready to move forward with their own markets. Thousands of firms nationwide have issued shares--mostly for their workers only--which are not yet authorized for trading. Officials are also considering ways of expanding share ownership to include foreign investors. But Beijing is moving slowly for fear of adverse social fallout: demand so far exceeds supply that both Shenzhen and Shanghai experienced run-away bull markets. Shenzhen's subsequent speculation-induced mini-crash chastened even market boosters. (CClarke) (CONFIDENTIAL)

VI. CHINA: DEFINING OWNERSHIP UNDER SOCIALISM (7/23)

Beijing is again exploring ownership reform as one means of making China's unprofitable state enterprises more efficient. Ideological constraints, lack of experience in adjudicating property rights, and the daunting task of defining current ownership are all hampering the efforts, as they did attempts in the 1980s.

Even during the reform heyday before the 1989 ouster of party chief Zhao Ziyang, reform of state industrial-enterprise ownership was a touchy subject. Ideology was adjusted in the 1980s to legitimate "pluralism" of ownership forms, allowing rapid expansion of China's small, largely service-oriented, private sector; collectives; and joint ventures with foreigners. Still, it was stipulated that state ownership must remain predominant in industry. Official media continue to attack the total privatization of state enterprises, but debate has now resumed, spurred by declining profitability and revenues, and by mounting subsidies.

Conservative "solutions". Some of China's long-running experiments are of dubious promise. For years China has promoted complicated contracting schemes intended to bestow greater initiative on enterprise managers. The bargaining underlying these contracts, however, results in sweetheart deals, corruption, and confusion, making it difficult to assess whether the contracts have in fact improved economic efficiency.

Lately, conservative leaders, including Premier Li Peng, have promoted "enterprise groups"--large, state-run conglomerates--as the way to bolster inefficient state firms and enhance the central government's management of the fragmented industrial economy. Proponents argue such groups--some focused on specific industries, others transcending economic sectors--would eliminate duplication of effort; rationalize use of labor, materials, and finances; promote economies of scale; and increase specialization. Critics counter they could also drag down efficient firms by merging them with losers and would cut competition.

Stock ownership, in many guises. Share issuance, widely used in the collective sector, is gaining a foothold in state enterprises--with the sanction of conservatives, eager to raise funds. The government continues to hold the vast majority of shares in public stock enterprises, but economists and policy advisers are debating whether the state must hold a majority of shares to retain a controlling interest. Officials are exploring schemes to separate ownership from management by setting up state holding companies that would issue shares to the public but retain the majority under state control. This, claims a proponent, would insulate management from the whims of both the government and public. Other advisers are promoting interlocking share ownership by government agencies and other state firms.

Who owns what? Before Beijing can move forward with any major ownership reform, it must clarify who owns which assets. Since 1988 a national state-property bureau has been trying to disentangle the complex web of national, provincial, local, collective, private, and foreign-enterprise investments to fix responsibility for asset management and define property rights. Bureaucratically outclassed by state industrial interests and unsure of political support, the bureau is

moving very slowly. Even with significant privatization, large industrial firms will face an underdeveloped system for handling property rights, lack of accountability of firms, and a large role by state property management agencies. (CClarke) (CONFIDENTIAL)

VII. CHINA: AFTER THE DELUGE (7/21/)

China is beginning to clean up after east China's most serious floods this century, but officials are warning that more flooding may occur, both in affected areas and further north. Handling the aftermath will be prolonged, difficult, and costly, and could give rise to political problems, both locally and among central leaders.

Two months of unusually heavy rains have resulted in major flooding in 18 of China's 30 provinces, affecting more than 100 million people and inundating as much as one-fifth of the country's cropland, according to official estimates. More than 1,700 people have died, and millions are homeless. China's agriculture minister warned that this year's harvest will be lower than last year's bumper crop; Chinese media estimates suggest flood losses to date could reduce grain production by as much as three percent--about equal to the PRC's grain imports last year. Industrial damage and work interruptions have also been heavy.

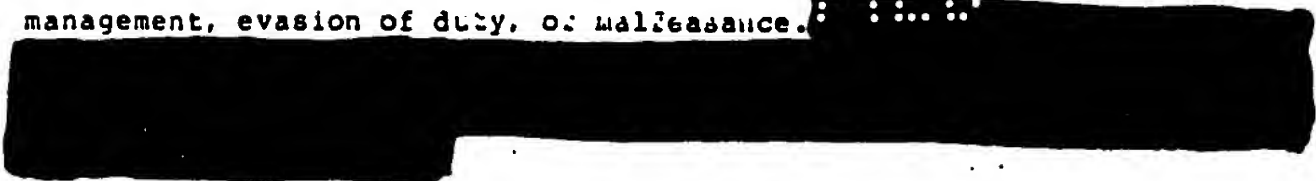
Near-term problems. Overall damage is estimated to surpass \$7.5 billion, with hundreds of thousands of houses destroyed. According to relief officials, as many as one-fourth of the people in the most severely hit areas are facing epidemics of hepatitis, dysentery, typhoid, malaria, and other diseases. Beijing has mobilized hundreds of thousands of military and civilian relief workers, but tents, blankets, food, medicine, and other supplies are short, and damage to transport infrastructure is severe.

Relief efforts have already caused some grumbling and local conflicts. In at least one case local residents attempted forcibly to resist plans to breach a dike and allow flood waters to destroy homes to save a railway bridge. State workers complain that appeals for donations have resulted in non-voluntary pay deductions, and plans to send as many as two million students to stricken areas during summer vacation will cause further disaffection.

Over the longer term the protracted and costly task of rebuilding will tax China's resources, undercutting efforts to reduce the budget deficit. Leaders are taking pains to show their personal concern and are using relief efforts to burnish the regime's--and the army's--prestige. But any bungling or corruption in clean-up efforts could later be used as a tool in leadership infighting.

Stern warnings and PR sensitivity. Beijing is thus taking steps to ensure that relief efforts do not give rise to charges of corruption; a sternly worded party directive threatened severe punishment for bad

management, evasion of duty, or malfeasance.



International appeal. Beijing swallowed its pride to make a highly unusual appeal for \$200 million in emergency international aid. So far the response has been modest: only about \$22 million has been pledged--most of this from Hong Kong--according to press reports. More donations are expected--Taiwan, for example, reportedly has already collected more than \$2.5 million--but foreign assistance is likely to fall far short of Beijing's request. (CClarke) (CONFIDENTIAL)